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SUPREME COURT OF THE UNITED STATES

October Term, 1959

No. 834

OLDHAM CLARKE, Trustee for Debtor,
Frank Fehr Brewing Co., - - - - Petitioner,

versus

UNITED STATES OF AMERICA, - Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

AND

BRIEF FOR THE PETITIONER

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Supreme Court of the United States

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OPINION BELOW

The opinion of the United States District Court for the Western District of Kentucky (Record 29a) is reported in 160 F. Supp. 631. The Court of Appeals for the Sixth Circuit affirmed the District Court without opinion.

JURISDICTION

The order of the Court of Appeals was entered on January 15, 1960 (Record, following 217b). Jurisdiction of this Court is invoked under 28 USC 1254(1).

QUESTION PRESENTED

Does the taking of an unauthorized deduction on a corporate income tax return constitute fraud with intent to evade tax and thus avoid the three year limitation on the assessment of additional taxes and penalties?

In this case a claim by the United States against the debtor corporation for additional income taxes for the years 1948 through 1952 is barred by the federal statute of limitations because not assessed within three years after the returns were filed for said years, unless for these years the debtor filed "false or fraudulent returns with the intent to evade tax" (26 USC 6501).

There is no substantial evidence in this case to justify the conclusion that the returns in question were "false or fraudulent with the intent to evade tax", and there is no finding of fact sufficient to support such conclusion.

The District Court held that, "The fraud lay in the representation to the Government that these amounts constituted office travel, or advertising expenses, were therefore legitimate deductions, when in truth and in fact they were not" (R. 36a).

The petitioner contends that this holding is erroneous and contrary to law in that such construction nullifies the statute of limitations.

STATUTES INVOLVED

26 USC 6501 (Internal Revenue Code of 1939 Sections 275 and 276) provides as follows:

> "Section 6501. *Limitations on Assessment and Collection.*
>
> (a) *General rule.*—Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) or, if the tax is payable by stamp, within 3 years after such tax became due, and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.
>
> * * * * *
>
> (c) *Exception.*—
>
> (1) *False return.*—In the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time."

26 USC 7454 (Internal Revenue Code of 1939 Section 1112) provides as follows:

> "7454. *Burden of Proof in Fraud and Transferee Cases.*
>
> "(a). *Fraud.*—In any proceeding involving the issue whether the petitioner has been guilty of fraud with intent to evade tax, the burden of proof in respect of such issue shall be upon the Secretary or his delegate. * * *"

STATEMENT

The Frank Fehr Brewing Co., a Delaware corporation, with its brewery and offices at Louisville, Kentucky, on August 13, 1957 filed a voluntary petition for corporate reorganization under the provisions of Chapter X of the Bankruptcy Act, and the petitioner, Oldham Clarke, was appointed Trustee.

On August 29, 1957 the respondent, United States of America, filed a CLAIM in the reorganization proceedings for $367,515.68 as additional income taxes, interest and penalties for the years 1948 to 1952 inclusive, and for the year 1954. This claim involves principally (a) officers' expenditures, (b) capital expenditures and (c) the salary paid Colonel Frank Fehr as president of the debtor (R. 34a).

The Trustee filed OBJECTIONS AND EXCEPTIONS to the tax claims, in which he denied the claims, and pleaded that the claims for additional taxes for the years 1948 to 1952 inclusive are barred by the federal statute of limitations (26 USC 6501) because not assessed within three years after the returns were filed for said years.

The United States filed a REPLY which pleaded that the returns for said years were "false and fraudulent with the intent to evade tax" and within the exception contained in the statute, on the alleged ground that each of the returns reported, "as legitimate and necessary business expenses sums of money paid to or on behalf of Frank Fehr and Fehr Kremer, officers of the debtor, in the amounts tabulated in the table

attached hereto, whereas in truth and in fact said amounts were used and expended by said officers individually and on their own behalf and had no connection with the legitimate and necessary business expenses of the Debtor."

By a PRE-TRIAL ORDER the District Court directed that a separate trial be had on the issue raised by the reply to the defense of the statute of limitations and that the United States had the burden of proving that any of the returns for the years 1948 to 1952 inclusive was a "false or fraudulent return with the intent to evade tax."

After an extended trial before the court without a jury on the question of limitations alone, the District Judge handed down a MEMORANDUM OPINION (160 F. Supp. 631) including findings of fact and conclusions of law to the effect that the returns were fraudulent (R. 29a). Before any order or judgment was entered the parties, without waiving their position on the question of limitations, stipulated certain facts concerning officers' expenditures, capital expenditures, and as to the salary of Colonel Fehr (R. 39a), and the United States moved for a summary judgment (R. 43a). The court then entered a judgment (R. 51a) which reads in part as follows:

> "1. That the Trustee's plea of the statute of limitations is denied, and Trustee's request for additional findings of fact and conclusions of law is overruled.
>
> "2. That the claim of the United States for additional income taxes for the years 1948 to 1952

inclusive, and the year 1954, is allowed in the amount of $117,153.69 as a priority claim under 11 USC Section 104(4).

"3. That the claim of the United States for interest on the aforesaid tax deficiency is allowed as a priority claim in the amount of $39,543.44, which is interest at the legal rate up to August 13, 1957, the date the petition was filed under Chapter X of the Bankruptcy Act.

"4. That the claim of the United States for penalties on the aforesaid deficiency in income taxes in the amount of $68,261.61 is denied in its entirety."

The Trustee prosecuted an appeal from the first three paragraphs above quoted from the judgment of the District Court, and the Court of Appeals affirmed the judgment without opinion.

Attached to the Reply of the United States is U.S.A. Exhibit No. 1 (R. 212b) in which are listed some 80 odd items of expenditures which were taken as deductions over a period of seven years on the corporate tax returns but which were claimed by the United States to represent personal expenses of Mr. Fehr Kremer and Col. Frank Fehr, the two principal officers, having no connection with legitimate and necessary expenses of the corporation. During the course of the hearing a revised exhibit was filed (Exhibit No. 60) in which some 76 items were listed covering the period of seven years (R. 215b).

The Government's claim of fraud was based largely upon an examination of the corporate records by

A. Joseph Zimmerer, an Internal Revenue Agent, Field Audit Branch of the Treasury Service at Louisville, and upon testimony of the witness Arlie Chastain,

The items thus described fall generally into the following categories: automobile expense; local hotels; social clubs; personal employees; out of town hotels; Florida expenses; television set and trunk. It was conceded by the Government's counsel that Mr. Zimmerer had no independent knowledge of whether these items were business expenses or not. The classification of items was based on information received by him from three informers, who were former employees of the company.

Arlie Chastain was Controller of the corporation during all of the years in question and in charge of the corporate books and records. He had been discharged prior to the hearing; he was an informer, and, as such, was interested in any recovery (R. 74a). He also admitted that in many instances he had given contrary evidence under oath in another proceeding (R. 53a). He testified that the questioned items were charged to expense because the officers concerned (Colonel Fehr or Fehr Kremer) told him to do so; that drafts on the company drawn by Colonel Fehr were charged as "office travel"; that both Colonel Fehr and Fehr Kremer signed petty cash vouchers; that these officers did not always substantiate the items. He handled the items in this manner in accordance with previous instructions on similar bills in the past but admits that he did not receive these instructions in every instance. He knew these officers took vacations and assumed the

expenses incurred were of a personal nature although he was not personally present. He claimed to know that sometimes the company automobiles were used for personal purposes; that some of the company employees were used for the personal purposes of the officers. He testified that he considered all of these items to be irregular on the corporate books (R. 25b) and that no adjustments were made on the tax returns (R. 48b).

Mr. Fehr Kremer, who was the corporation's chief executive officer at the times under review, and when it filed its reorganization petition, and Colonel Fehr, each testified that they not only intended to do so, but that in their opinion they did, in each year, reimburse the corporation for all items expended on their behalf by the corporation which were not proper corporate expenses (R. 62a, 56a, 56b and 135b).

The officers who signed the returns (R. 35a), the accountants who prepared the returns (R. 71a), and the directors of the corporation (R. 36a) all were of the opinion that the expense items were proper expenditures for the corporation and therefore deductible.

ARGUMENT

The District Court and the Court of Appeals have erroneously decided an important question of federal law and of the administration of the revenue laws, which have not been, but should be, settled by this Court. Rule 19(b).

There is no contention that the claim of fraud is based upon the conduct of the corporation in keeping a double set of books; in making false entries or alterations; in making false invoices or documents; in the destruction of books or records; in the concealment of assets or covering up sources of income or of failing to keep usual and customary records. The above actions by a taxpayer were described by this Court as comprising the most usual and common circumstances which possibly justify the inference of a fraudulent intent. *Spies* v. *U. S.*, 317 U. S. 492, 63 S. Ct. 364, 87 L. Ed. 418. While the above statement was made in a criminal case and while there may be a difference in the character of proof required between a criminal and a civil case, that general statement is equally applicable to a charge of fraud in a civil case.

The present petition does not present any questions with respect to the tax returns of the individuals concerned. Whether the tax returns of the two officers of the corporation contained understatements of income is not now before the Court. The sole question is whether the tax returns of the corporation were fraudulent.

I.

There Is No Presumption of Fraud Merely Because a Return Incorrectly Contains Unauthorized Deductions

The question as to when and under what circumstances a corporate income tax return shall be deemed fraudulent is one which remains largely unexplored by the courts. Most of the decided cases have involved the returns of individuals.

The problem, as relates to corporate returns, involves a reconciliation of proper corporate action on the one hand, with the technical requirements of the Internal Revenue Code on the other. Proper and legitimate corporate action is one thing. The determination of whether such action involves an expense which is deductible as being "ordinary and necessary" within the technical meaning of the Code is quite another.

From the corporate point of view it has never been suggested that it was improper in any sense for the corporation to furnish an automobile for its executives, or to pay their club dues, or travel or entertainment expense or even to give them expense paid vacations. But whether, and to what extent, such items may be transferred into the tax returns as deductible expense items requires an intimate and exhaustive knowledge of court decisions, regulations and interpretations, with little or no guidance even with such information.

This court itself has characterized this problem as "a field necessarily beset by innumerable complexities." *Commissioner of Internal Revenue* v. *Hein-*

inger, 320 U. S. 467, 475, 88 L. Ed. 171, 177, and this Court has further said, with reference to the words "ordinary and necessary", in *Welch* v. *Helvering*, 290 U. S. 111, 114, 78 L. Ed. 212, 215, that:

> "Here, indeed, as so often in other branches of the law, the decisive distinctions are those of degree and not of kind. One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle."

For these reasons the courts have uniformly held that the mere fact that a return is incorrect, or contains unauthorized deductions, creates no presumption that the return is fraudulent. *Davis* v. *Commissioner*, 10 Cir., 184 F. 2d 86, 22 ALR 2d 967; *Hawkins* v. *Commissioner*, 6 Cir., 234 F. 2d 359.

As said in *Davis* v. *Commissioner, supra:*

> "Fraud implies bad faith, intentional wrongdoing and a sinister motive. It is never imputed or presumed and the courts should not sustain findings of fraud upon circumstances which at the most create only suspicion."

In other words, for a corporate return to be held fraudulent more must be shown than that the return was incorrect. It must be shown that the corporate taxpayer was familiar with the tax law applicable to corporations and deliberately filed its return with the express intention of evading its taxes.

Nothing of this sort was shown in this case and no such finding was made by the District Court as will be later shown here.

II.

There Can Be No Inference of Fraud Where the Corporate Tax Returns Were Made by Certified Public Accountants

For the same reasons above stated, the courts have uniformly held that there can be no inference of fraud where the corporate returns are made by Certified Public Accountants. *Hatfried, Inc.* v. *Commissioner,* 3 Cir., 162 F. 2d 628; *Haywood Lumber and Mining Co.* v. *Commissioner,* 2 Cir., 178 F. 2d 769; *Davis* v. *Commissioner, supra; John P. Winn,* 12 T.C.M. 886; *U. S.* v. *Pechenik,* 3 Cir., 236 F. 2d 844, and many other cases that might be cited.

The complexities of the income tax law are so great that practically all corporations and a great many individuals find it necessary to employ accountants to make out their returns. In the present case the tax returns for all of the years in question were made by the firm of Escott, Grogan & Co., a highly reputable firm of accountants in the city of Louisville (R. 32a). That firm had done the auditing and tax work for the corporation since its organization.

Neither of the officers concerned nor Mr. Chastain, the Controller, had anything to do with making out the tax returns except to sign them.

Tax returns are required to be made out in the precise manner indicated by various tax forms. In the

process of making the annual audits and preparing the tax returns all of the books and records of the corporation were made available to the accountants (R. 128b). Substantial items were customarily discussed with the management and the auditors always made such reasonable investigation as the situation required. Any item which was considered by the accountants to be nondeductible for income tax purposes would be eliminated (R. 102b).

The corporate records contained evidence of all the expense items now in question, although as to some of them there was a lack of supporting data (Comment by Court, R. 136b). In making the annual audits and in preparing and filing the tax returns, the accountants used their own independent judgment as to whether the questioned items should be taken as deductions from gross income in determining net taxable income. Mr. Escott testified that the question of what expenses are "necessary and ordinary" frequently becomes a matter of opinion and of company policy and of the good faith judgment of the accountant as to how they should be handled (R. 132b). His firm took the responsibility in making and filing the tax returns and it is not a material question in this case as to whether their decisions were erroneous or not.

In view of the necessary practice of employing accountants in preparing tax returns it has been uniformly held that there can be no fraud where the returns are made in this manner and all records are made available to the accountants.

III.

There Is a Presumption That the Returns Were Correct After They Were First Examined by Revenue Agents.

Prior to the examination of the returns which were the basis of the Government's claim of fraud in the reorganization proceedings, each of the returns had been examined by revenue agents. The 1948 return was examined in 1950 and other returns were examined in 1951 and 1953 (R. 13a, 14a). In each of these examinations some small deficiency in tax was found but no question was raised as to the expense items involved in the present action.

The testimony shows that at the time of these several examinations the revenue agents had full access to the company records and with full opportunity for discussion of the returns with the officers of the corporation and with the company's accountants. In the absence of evidence to the contrary, it must be assumed that these revenue agents properly performed their functions, that they were aware of these expense items and passed them as being proper deductions.

It is common knowledge that only within the past year has the Internal Revenue Service extensively publicized its Rules and Regulations with respect to travel and entertainment expense and kindred items.

At the time the returns in question were filed, it was the common practice of many corporations to make literal allowance for travel and entertainment expense and to report these expenses as deductible items

on their tax returns without being seriously questioned. Such liberal treatment may be evidenced by a great number of cases, among which might be cited *Cohan* v. *Commissioner*, 2 Cir., 39 F. 2d 540; *Ralph E. Duncan*, 30 T.C. 386; *Gaines, Inc.*, 10 T.C.M. 284; *Faitoute Iron & Steel Co.*, 11 B.T.A. 818, and also many more recent cases in which might be included *Silverman* v. *Commissioner*, 8 Cir., 253 F. 2d 849; *Finley* v. *Commissioner*, 10 Cir., 255 F. 2d 128; *Williams* v. *U. S.*, 5 Cir., 245 F. 2d 559.

These cases are of importance primarily because in none of them was any question of fraud even suggested. The reason for this is quite plain. The dividing line between what expenses for travel, entertainment, advertising and similar corporate purposes are proper deductions, and which are not, has never been adequately defined by law, the regulations or the decisions of the courts as we have previously pointed out. Here again the distinction between corporate action as such and technical tax returns becomes of prime importance as does the distinction between corporate returns and returns of individuals. And again the importance and, in fact, the necessity of the employment of reputable accountants upon whom the corporation can rely to file correct returns, becomes most material.

IV.

The Conclusion that the Returns Were Fraudulent Is Not Supported by the Evidence or the Findings of the District Court

The Court of Appeals did not write an opinion in the case but merely entered an order that the judgment of the District Court be affirmed on the opinion of the District Judge reported in 160 F. Supp. 636. Consequently, it is necessary to go back to the opinion and findings of fact of the District Court. The basis of the holding of fraud is the finding (R. 36a) that:

> "The fraud lay in the representation to the Government that these amounts constituted office, travel, or advertising expenses and were, therefore, legitimate deductions when, in truth and in fact, they were not."

This is nothing more than a conclusion that an incorrect return is always fraudulent. If this principle is correct, any error in a return is a misrepresentation and, consequently, fraudulent. This conclusion was clearly erroneous.

The Court did find that in many instances there was a lack of supporting data for the various items and that in many instances there was no recorded authorization for the expenditure (R. 33a to 35a).

On the other hand, there was a finding that there was a belief that these were legitimate corporate expenses and that they were approved by the Board of Directors (R. 35a, 36a).

There was no finding that these items were known to the officers of the corporation to be nondeductible

items or that they should have had such knowledge. In the absence of a finding of bad faith or intentional wrongdoing or in the absence of finding facts from which such intention might clearly be presumed, it was error to hold the returns fraudulent.

CONCLUSION

It is earnestly insisted not only that the decision below is erroneous but that it establishes a principle which nullifies the statute of limitations on the assessment of additional income taxes and makes it impossible for any taxpayer to be secure from the threat of additional income taxes being imposed for years long past. It, in effect, means that there is no limitation at all on the assessment and collection of income taxes, because if the decision below is correct, any incorrect return is fraudulent, and therefore always open to examination. Manifestly Congress desired to place a limitation on the time for such assessments and we urge the Court to construe the statute in such a way as to effectuate this intent.

A writ of certiorari should be granted.

Respectfully submitted,

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